The United States Trustee respectfully objects to the application by debtor Pacific Gas & Electric Company (PG&E) to employ Dresdener Kleinwort & Wasserstein (DrKW) as financial advisors and investment bankers. The terms of employment include PG&E's agreement 1) to indemnify DrKW for negligence committed in the course of its work in the case and 2) to resolve all performance disputes in New York subject to the laws of New York.[1/] Neither term is appropriate in a Chapter 11 debtor employment contract with a professional.

I. INTRODUCTION

Contractual arrangements holding persons harmless for negligence are generally disfavored in the law. They are particularly inappropriate with respect to bankruptcy professionals who act as fiduciaries for the estate when employed by the debtor.[2/] As part of the employment agreement with DrkW, PG&E also agrees that law suits about the engagement will take place in New York subject to the laws of New York. This term is inconsistent with, and undermines, this Court's statutory control of fees and terms of employment.

II. INDEMNIFICATION PROVISIONS AND LIMITS ON THE AMOUNT OF DAMAGES ARE INHERENTLY INCONSISTENT WITH THE PROFESSIONAL ROLE OF FINANCIAL ADVISORS.

A. Indemnification Permits Conduct below the Standard of Care.

"Exculpatory contracts are not favored by the law because they tend to allow conduct below the acceptable standard of care." *Yauger v. Skiing Enterprises, Inc.*, 206 Wis.2d 76, 81, 557 N.W.2d 60, 62 (1996); *Celli v. Sports Car Club of America, Inc.,* 29 Cal. App. 3d 511, 518 (1972); 17 Am. Jur. 2d, Contracts § 297 & n.72 (1991). See, also, *e.g., Tunkl v. Regents of Univ. of Calif.,* 60 Cal.2d 92,96 (1963) (exculpatory clauses which affect the public interest are not enforceable); *Cohen v. Kite Hill Community Assn.,* 142 Cal.App.

[1/] See Exhibit B to Debtor's application to employ DrKW, p.4 and the separate April 6, 2001 letter regarding indemnity appended to Exhibit B.

[2/] PG&E's agreement to limit the amount of damages to a figure related to DrKW's fee, if a court finds negligence will lie, is also objectionable. It is simply an aspect of the indemnity agreement controlling the amount of damages payable as indemnity.

3d 642, 655 (1983) (homeowners associations occupy a position of trust and an exculpatory clause is not enforceable). Indemnification provisions in a professional services contract are particularly inappropriate.

An arrangement with a professional to provide services is not strictly commercial. A "profession" is a "vocation or occupation requiring special, usually advanced, education, knowledge, and skill; *e.g.* law or medical professions." Black's Law Dictionary 1089 (5th ed. 1979). Because a professional person is charged with exercising a special degree of care in the discharge of services reflecting that special skill, requests to be excused from the consequences of negligence are viewed as unseemly. "It is tacky, to say the least, for a professional to hide behind such a clause." *In re Healthco Int'l., Inc.*, 195 B.R. 971, 987 (Bankr. D. Mass. 1996) (financial advisory services).[3/]

In the legal profession, the rules of ethics prohibit attorneys from accepting indemnity in connection with professional services. California Rules of Professional Conduct, R. 3-400. Model Code of Professional Responsibility DR 6-102; Model Rules of Professional Conduct Rule 1.8(h); *see also In re Mortgage & Realty Trust*, 123 B.R. 626, 630 (Bankr. C.D. Cal. 1991) ("ethics rules prohibit an attorney from obtaining an indemnity from a client in connection with professional services"). Under the Model Code of Professional Responsibility DR 6-102, a lawyer is prohibited from even attempting "to exonerate himself from or limit his liability to his client for his personal malpractice."

B. Financial Advisers, like Attorneys, are Professionals.

Financial advisors, who hold themselves out as professionals and who are subject to the same standards of scrutiny under §§ 327 and 328, must be subjected to strictures similar to attorneys. The degree of learning and skill brought to their task is comparable. As with other professional negligence, a financial advisor's mistakes can engender serious injuries; the mistakes can cause losses to the estate and even force a liquidation. *See*, *e.g., In re Merry-Go-Round Enterprises, Inc.*, 244 B.R. 327, 330-31, 333

[3/] In *Healthco*, the court expressly agreed with the bankruptcy cases refusing to approve indemnification clauses. 195 B.R. at 987 & n. 64. The court distinguished between bankruptcy approval and judicial enforcement of a prepetition agreement.

(Bankr. D. Md. 2000) (accounting firm, retained in Chapter 11 case to provide services to the debtor as a "turnaround specialist," settles negligence, malpractice, fraud and fraudulent concealment suit brought by the estate for $185 million); *Billing v. Ravin, Greenberg & Zackin, P.A.*, 22 F.3d 1242 (3d Cir. 1994) (professional accused of malpractice for failing to perform a number of duties); *Southmark Corp. v Coopers & Lybrand (In re Southmark Corp.)*, 163 F.3d 925, 928 (5th Cir. 1999) (unsuccessful multimillion dollar malpractice action against accountants).

While some courts have allowed indemnity agreements with debtor's financial advisors, *In re Joan and David Halpern, Inc.,* 248 B.R. 43 (Bankr. S.D.N.Y. 2000), the weight of authority and the better view condemn them. *In re Allegheny Int'l, Inc.*, 100 B.R. 244, 247 (Bankr. W.D. Pa. 1989) ("holding a fiduciary harmless for its own negligence is shockingly inconsistent with the standard of care required"); *In re Mortgage & Realty Trust*, 123 B.R. 626, 63 (Bankr. C.D. Cal. 1991) ("[i]ndemnification is not consistent with professionalism"); *In re Drexel Burnham Lambert Group*, 133 B.R. 13, 27 (Bankr. S.D.N.Y. 1991) ("[s]imply stated, indemnification agreements are inappropriate"); *In re Gillett Holdings, Inc.*,137 B.R. 452, 458 (Bankr. D. Colo. 1991) ("entirely improper and unacceptable").

DrKW is entitled to no more protection than that afforded other PG&E professionals, such as attorneys. In no event should they be authorized to obtain indemnification in advance. *In re Gillett Holdings, Inc.*, 137 B.R. 452, 458 (Bankr. D. Colo. 1991). See, also, *Realty Trust*, 123 B.R. at 630-31; *In re Drexel Burnham Lambert Group*, 133 B.R. at 27.

Under section 327 of the Code, a professional can be employed only if its retention is necessary. If the debtors can perform those duties without assistance, it is improper to retain a professional. *Boldt v. United States Trustee (In re Jenkins),* 130 F.3d 1335, 1341 (9th Cir. 1997) ("Section 327 allows trustees to hire professionals to perform services requiring special expertise beyond that expected of an ordinary trustee."). Given that professionals provide important services, the bankruptcy system must ensure those "professionals would be especially diligent in making sure that they meet the standard of care for exercising their expertise in their work in the case." *Realty Trust*, 123 B.R. at 631.

C. As a Professional, DrKW Should Be Held to the Highest Level of Care.

No question exists that DrKW holds itself out as a professional having special skills, even within its specialty:

> The Investment Banking Division has over 8000 professionals in more than 30 locations around the world, including a major presence in the key financial centers of London, Frankfort and New York. In the year 2000, the Investment Banking Division ranked as one of the leading global M&A houses, advising on M&A deals with a total value in excess of $440 billion.
>
> ...
>
> DrKW and/or its current professionals have extensive experience working with financially troubled companies in complex financial restructurings out of court and in chapter 11 cases.
>
> ...
>
> For example, Kenneth A. Buckfire, the Managing Director of DrKW who will be primarily responsible for this engagement has extensive experience in restructuring of utilities.

Debtor's application for employment of DrKW, pp. 3-4. DrKW is being asked to play a central role in the reorganization, including assisting in devising and negotiating a plan of reorganization and securities that may be issued under a plan, as well as testifying before the court, the legislature and the California Public Utilities Commission. It may be able to seek a success fee of up to $20 million.

This court should prohibit the indemnification of DrKW. Allowing indemnification clauses in a contract for professional services demeans the meaning of being a professional. These clauses could encourage professionals to ignore their high standard of care. In bankruptcy, they could impair the ability of the debtor client to recover on behalf of the estate if the professionals fail to perform their duties.

D. The Logic Behind Court Decisions Refusing to Allow Securities Underwriters to Enter Indemnification Contracts with their Issuer Clients Supports a Ruling by this Court Refusing to Allow PG&E to Enter an Indemnification Agreement with DrKW

Substantial support for disallowing PG&E's indemnity of DrKW is drawn from court decisions refusing to allow securities underwriters to enter into indemnification contracts with their issuer clients. *Eichenholtz v. Brennan*, 52 F.3d 478, 484-86 (3d Cir. 1995) (court refused to uphold an indemnification contract because indemnification is inconsistent with the policies underlying the securities laws even though the provision did not

violate any express statutory provision); *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203, 216 (3d Cir. 2000) (citing *Eichenholtz* with approval). See, also, *Laventhol, Krekstein, Horwath & Horwath v. Horwitch*, 637 F2d 672, 675-76 (9th Cir. 1980) (Ninth Circuit affirms dismissal of a claim for indemnity as contrary to the policies underlying the Securities Act of 1933 because "permitting indemnity would undermine the statutory purpose of assuring diligent performance of duty and deterring negligence."); *Nelson v. Bennett*, 662 F.Supp. 1324, 1328 (E.D.Cal. 1987) (citing *Laventhol* for proposition that indemnification is counter to "assuring diligent performance of duty and deterring negligence.")

In *Eichenholtz*, 52 F.2d 479-81, the Third Circuit, upholding a district court decision, approved a class action settlement and extinguished contractual indemnity rights a securities issuer granted to a non-settling underwriter. *Id.,* 479-81, 484-86. Before reaching the contractual question, the court rejected the underwriter's argument that securities laws gave it an implied right of action to obtain indemnification from the issuer. The court stated securities laws are not primarily drafted "to protect..underwriters, but rather... investors." *Id.* at 483. *Accord, Laventhol*, 637 F.2d at 675-676. The Third Circuit held that indemnifying underwriters served no valid public purpose because it would be "the underwriters, not the victims, who [would] seek indemnification." *Id.* at 483-84. Accord, *Laventhol, id.*

The indemnity in *Eichenholtz* included the underwriter's "negligent ... performance of its duties." The court refused to sanction these contracts because they undercut the underwriter's incentive to perform its duties competently. *Id.* at 484-86. The court noted "[t]he underlying goal of securities legislation is encouraging diligence and discouraging negligence in securities transactions." *Id.* at 484. *Accord, Laventhol*, 637 F.2d at 675-676. "These goals are accomplished by exposing issuers and underwriters to the substantial hazard of liability for compensatory damages." *Id.* (internal quotation marks omitted).[4]

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[4] Accord, *Globus Law Research Serv., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969) *cert. denied*, 397 U.S. 913 (1970) (citing the "'*in terrorem* effect' of civil liability"). As the *Globus* court noted, prohibiting the indemnification of underwriters

The logic of *Eichenholtz* fully applies to bankruptcy professionals. Like underwriters, bankruptcy professionals are hired to assist their clients in their dealings with third parties who "depend" on the professionals' work.[5] Bankruptcy professionals' "incentive" to accomplish their important tasks could be just as "effectively eliminated" as underwriters' incentive if they could obtain indemnification.

For these reasons, bankruptcy professionals "may not absolve themselves of such a broad range of potential liability or responsibility for their own actions." *Gillett*, 137 B.R. at 458.

III. INDEMNIFICATION PROVISIONS ARE ESPECIALLY INAPPROPRIATE IN A CHAPTER 11 CASE WHERE DEBTOR'S PROFESSIONALS HAVE A FIDUCIARY OBLIGATION TO THE ESTATE.

A. As PG&E's Investment Adviser, DrKW Has Special Legal and Public Duties

In addition to disallowing the indemnification provisions based on judicial policies respecting the standards of conduct demanded from professionals, these provisions in the DrKW contract should be voided on an independent basis. DrKW's provision of services as a professional financial advisor to the debtor in a bankruptcy case imbues the firm with special legal and public duties. DrKW will become a fiduciary to the estate. Allowing duties of a fiduciary to be subject to exculpatory treatment is a slippery slope.

"[A] contract for exemption from liability for negligence is void and unenforceable if it is violative of law or contrary to some rule of public policy." 17A C.J.S. Contracts § 262 at p. 268. *Tunkl v. Regents of Univ. of Calif.,* 60 Cal.2d 92,96 (1963); *Cohen v. Kite Hill Community Assn.,* 142 Cal.App.3d 642, 655 (1983). Public policy considerations bar such arrangements "in the performance of a legal duty or a duty of public service, or where a

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> ensures that an underwriter will not be able to increase the issuer's liability while totally avoiding any injury to himself. In both instances, the proper purpose of the Act is to encourage diligence, investigation and compliance with the requirements of the statute by exposing issuers and underwriters to the substantial hazard of liability for compensatory damages.

Id. at 1289.

[5] Indeed, the position of the creditors would render the logic of *Eichenholtz* even more compelling in the bankruptcy context. Unlike the typical public investor, the creditor in a bankruptcy case is not there voluntarily and is not choosing to rely upon the financial advisor's advice.

public interest is involved or a public duty owed, or, when the duty owed is a private one, where public interest requires the performance therefor." 17A C.J.S. Contracts § 262 at pp. 270-71. Or, as the court in *Rosenthal v. Bologna*, 211 A. D.2d 436, 437, 620 N.Y.S.2d 376, 377 (N.Y. A.D. 1995) (citation omitted) explained,

> Contractual clauses which purport to exculpate a party from liability for its own negligence are disfavored and invite close judicial scrutiny. Normally, such exculpatory agreements will be upheld in a purely commercial setting, or where voluntary nonessential social activities are freely engaged in by consenting parties.

Needless to say, the services of the financial advisor in this case cannot be described as "nonessential." If DrKW's services were not essential, they should not have been sought by PG&E – either with or without indemnification provisions.

B. PG&E's Employment Contract with DrKW is Not in a Purely Commerical Environment

. Not only are DrKW's services essential, it cannot even be remotely suggested that DrKW is providing services in a "purely commercial setting." In a commercial setting, the parties would not be submitting the retention agreement to a federal court for a mandatory, independent review of its reasonableness. This transaction was submitted for approval in the highly regulated environment of a Chapter 11 reorganization, and the United States Trustee is objecting. The objection addresses the reasonable contractual parameters for indispensable, professional services required to maximize the chances for continued fiscal viability.

Bankruptcy fiduciaries have always been held to particularly high standards of honesty and loyalty. See, generally, *Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262, 278 (1941) (trustees); *Mosser v. Darrow*, 341 U.S. 267 (1951) (same). See *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928). As Chief Judge Cardozo explains in *Meinhard*, "[m]any forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties." *Id*. See also *Wilshire-Doheny Associates Ltd. v. Shapiro*, 83 Cal.App.4th 1380 (2000)(California Corporations Code §317 allowing corporations to indemnify their agents [management] unless they act as fiduciaries

or breach fiduciary duties); *Cohen v. Kite Hill Community Assn.,* 142 Cal.App. 3d 642, 655 (1983) (homeowners associations occupy a position of trust and exculpatory clause is not enforceable).

C. On April 6, 2001 when PG&E Filed a Chapter 11 Petition, the Standard for an Appropriate Professional Contract Changed.

In the workaday world outside of bankruptcy, it may be appropriate for some companies to bestow indemnity on their professionals. But, in a bankruptcy case, it is improper for a provider of professional services, seeking court approval under 11 U.S.C. §§ 327 and 328, to seek a blank check that may wind up being drawn on the bank accounts of its creditors and the estate.

In the course of enacting the Bankruptcy Reform Act of 1978, the legislators explained:

> The practice in bankruptcy is different for several reasons. First, there is a public interest in the proper administration of bankruptcy cases. Bankruptcy is an area where there exists a significant potential for fraud, for self-dealing, and for diversion of funds. In contrast to general civil litigation, where cases affect only two or a few parties at most, bankruptcy cases may affect hundreds of scattered and ill-represented creditors. In general civil litigation, a default by one party is relatively insignificant, and though judges do attempt to protect parties' rights, they need not be active participants in the case for the protection of the public interest in seeing disputes fairly resolved. In bankruptcy cases, however, active supervision is essential. Bankruptcy affects too many people to allow it to proceed untended by an impartial supervisor.

H.R. Rep. No. 95-595, at 88 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6050 (footnotes omitted). *Cf., Gunter v. Ridgewood Energy Corp.*, 223 F.3d 190, 191-92 (3d Cir. 2000) (requiring district courts to engage in a thorough and independent review of fee requests in common fund cases).

Prior to seeking the substantial protections afforded under bankruptcy, neither debtors nor their officers and directors owe any special duty to their corporations' creditors in determining how much to pay their professionals. But this duty totally changes when debtors seek protection under Chapter 11 of the Bankruptcy Code. In becoming debtors in possession, debtors accept the mantle of fiduciary, thereby obligating themselves to perform their duties in the way that best serves the interests of their creditors and the estate. *CFTC*

v. Weintraub, 471 U.S. 343, 355 (1985) (holding debtors in possession have a fiduciary duty to their creditors); *Official Comm. of Unsecured Creditors of United Healthcare Sys., Inc. v. United Healthcare Sys., Inc*. (*In re United Healthcare Sys., Inc.*), 200 F.3d 170, 177 at n.9 (3d Cir. 1999), *cert. denied*, 530 U.S. 1204 (2000) (applying *Weintraub* and 11 U.S.C. § 1107(a) to hold "a debtor-in-possession[] is a fiduciary for its estate and its creditors"). "Indeed, the willingness of courts to leave debtors in possession 'is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.'" *Weintraub,* 471 U.S. at 355 (quoting in part *Wolf v. Weinstein*, 372 U.S. 633, 649-52 (1963)).

For these reasons, the law requires debtors in possession to consider not whether they are willing to take a risk, but whether taking that risk could adversely affect the estate. In as much as they are fiduciaries, they must now "exercise control" over the "management" of the company in a way that fairly protects the interests of the estate. *Weintraub*, 471 U.S. at 356 (debtor in possession must manage attorney-client privilege in a way that is consistent with the "obligation to treat all parties, not merely the shareholders, fairly"). In negotiating an employment agreement with DrKW, PG&E, as a debtor in possession, is required to satisfy itself that it is acting fairly to the estate before it seeks to bestow indemnification upon DrKW. *Everett v. Perez (In re Perez*), 30 F.3d 1209, 1214 (9th Cir. 1994) (Chapter 11 debtor must satisfy itself that cramdown is proper before so certifying to the court). PG&E fails to meet that requirement.

D. Potential Negligence Claims against DrKW are Property of the Estate, not PG&E

Potential negligence claims against a financial advisor are property of the estate. 11 U.S.C. § 541(a)(7). Absent the promise of indemnification, debtors in possession have a fiduciary duty to seek recovery for the benefit of the estate from a negligent financial advisor for that loss. See, generally, *Integrated Solutions, Inc. v. Service Support Specialities, Inc.*, 124 F.3d 487, 491 (3d Cir. 1997); *Billing v. Ravin, Greenberg & Zackin, P.A.*, 22 F.3d 1242 (3d Cir.), *cert. denied*, 513 U.S. 999 (1994); *In re Thompson*, 116 B.R.

679, 682 (Bankr. W.D. Ark. 1990); see, also, *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 474 (3d Cir. 1998) ("among the fiduciary obligations of a debtor-in-possession is the 'duty to protect and conserve property in its possession for the benefit of creditors'") (quoting in part *In re Ionosphere Clubs, Inc.,* 113 B.R. 164, 169 (Bankr. S.D.N.Y. 1990)). See, also, *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 12 (2000) (noting that a trustee - and thus by inference a debtor in possession - must pursue a claim under 11 U.S.C. § 506(c) because "the trustee is obliged to seek recovery under the section whenever his fiduciary duties so require."); and, *Ford Motor Credit Co. v. Reynolds & Reynolds Co. (In re JKJ Chevrolet, Inc.)*, 26 F.3d 481, 485 (4th Cir. 1994).[6] PG&E, the debtor in possession in this case, is failing to put the estate first by agreeing to the indemnification provisions sought by DrKW,.

Bankruptcy does not allow a debtor in possession to give up a potentially valuable claim or sell property when the debtor has no idea what it might be worth. To the contrary, to ensure estate property is sold only for full value, all sales are conditioned upon notice, a hearing, and a court determination that the disposition of property is in the best interests of the estate. *Northview Motors, Inc. v. Chrysler Motors Corp.*, 186 F.3d 346, 350-51 (3d Cir. 1999) (construing 11 U.S.C. § 363); accord, *In re Baciagalupi,* 60 B.R. 442, 446-447 (9th Cir. BAP 1986). Compromise of a claim requires the court to make factual findings that show the compromise or release of the claim is in the best interests of the estate. *In re A&C Properties,* 784 F.2d 1377, 1380-81 (9th Cir. 1986).

This is not a case where the debtor in possession wants to sell an asset after it has extensively marketed it, appraised it, and solicited bids. PG&E is seeking approval from the court to give up a right to seek a recovery for the estate with no notion of what that right might be worth. The indemnification is inconsistent with PG&E's obligations as a debtor in possession for prudent management of estate property.

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[6] *Cf. Myers v. Martin*, 91 F.3d 389, 394 (3d Cir. 1996) ("it is the trustee's duty to both the debtor and the creditor to realize from the estate all that is possible for distribution among the creditors") (quoting 4 *Collier on Bankruptcy* ¶ 704.01 15th ed. 1993).

IV. THE AGREEMENT TO HAVE DISPUTES DECIDED IN NEW YORK PURSUANT TO NEW YORK LAW IS NOT CONSISTENT WITH THIS COURT'S JURISDICTION TO CONTROL EMPLOYMENT TERMS AND FEES

PG&E has agreed to have disputes with DrKW decided only in New York, pursuant to New York law. This term is inconsistent with Bankruptcy Code §§ 327 - 330, which give this court exclusive control of employment terms and fees in bankruptcy cases. See *In re Shirley*, 134 B.R. 940, 943-44 (9th Cir. BAP 1992), ("Bankruptcy Code and Federal Rules of Bankruptcy Procedure operate to preclude fee awards for services performed on behalf of a bankruptcy estate based on state law theories not provided for by the Code"). *Accord*, *In re Atkins*, 69 F.3d 970, 973 (9th Cir. 1995); and, *In re Weibel*, 176 B.R. 209, 211 (9th Cir. BAP 1994).

V. CONCLUSION

For the reasons stated, the U.S. Trustee submits the employment of DrKW should not be allowed unless the terms are stricken that provide indemnity for negligence, limitation on the amount of damages, and dispute resolution in New York under the laws of New York.

Date: June 20, 2001

Respectfully submitted,

By: _____
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UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

In re	No.	01-30923 DM
PACIFIC GAS & ELECTRIC COMPANY,	Chapter	11
Debtor.	Date:	July 10, 2001
	Time:	9:30 p.m.
	Place:	235 Pine St., 22nd Floor San Francisco, California

UNITED STATES TRUSTEE'S OBJECTION TO PG&E'S APPLICATION TO EMPLOY DRESDENER KLEINWORT & WASSERSTEIN